No. 94, Original

IN THE SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1986

STATE OF SOUTH CAROLINA,
PLAINTIFF,

NATIONAL GOVERNORS' ASSOCIATION,
PLAINTIFF-IN-INTERVENTION,

v.

JAMES A. BAKER, III, SECRETARY OF THE
TREASURY OF THE UNITED STATES OF AMERICA,
DEFENDANT.

EXCEPTIONS OF THE STATE OF SOUTH CAROLINA TO THE REPORT OF THE SPECIAL MASTER AND BRIEF IN SUPPORT THEREOF

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QUESTIONS PRESENTED

1. Application of the penalty provision of Section 103 of TEFRA which requires federal taxation of the proceeds of the State of South Carolina's bond issues unless the bonds are issued in accordance with congressional regulations violates the doctrine of reciprocal tax immunity and the Sixteenth Amendment.

2. Application of the penalty provision of Section 103 of TEFRA which requires federal taxation of the proceeds of the State of South Carolina's bond issues unless the bonds are issued in accordance with congressional regulations violates the Tenth Amendment and notions of Federalism.

JURISDICTION

This action is an original jurisdiction matter. South Carolina v. Regan, 465 U.S. 367 (1984). The Honorable Samuel J. Roberts, Special Master, appointed pursuant to the order of this Court, 466 U.S. 948, issued his report on January 22, 1987.

This Court received the report on February 23, 1987, and issued its order granting the parties forty-five days to file exceptions with supporting briefs. On March 11, 1987, this Court granted South Carolina's request for additional time to file its exceptions to the Report of Special Master (hereinafter Report) until May 9, 1987.

STATEMENT

This case presents the question of whether Congress may impose as a penalty the loss of tax immunity for the proceeds of the State of South Carolina's general obligation bond instruments if the State fails to issue its bonds in registered form -- the method preferred by Congress. The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), Pub. L. No. 97-248, 96 Stat. 595, Section 310(b)(1), codified at 26 U.S.C. Section 103(j) (1982), denies an exemption for federal income tax on interest paid on any "registration required" obligation unless the obligation is in registered form. Section 310(b)(1) provides:

> (j) Obligations must be in registered form to be tax-exempt
>
> Nothing in subsection (a) or in any other provision of law shall be construed to provide an exemption from Federal income tax for interest on any registration-required obligation

> unless the obligation is in registered form.

Section 310(b)(1) defines registration-required obligations broadly to include most publicly offered municipal obligations with maturities of issue of one year or more. The Master concluded that "[s]ince the forfeiture of tax-exempt status would increase the interest that states and localities have to pay on their obligations by some 28% to 35%, Section 310(b)(1) in effect requires the registration of all municipal bonds." Report at 2 (footnote omitted).

In determining to exercise original jurisdiction, four of the Justices -- the former Chief Justice, Justices Brennan, Marshall and White -- found it to be unquestionable that "the manner in which a State may exercise its borrowing power is a question that is of vital importance to all 50 States." Regan, 465 U.S. at 382. Justice

Blackmun said the issue presented was "a substantial one" and "of concern to a number of States." Id. at 384.

An additional three Justices -- O'Connor, Powell and Rehnquist -- found the authority claimed by South Carolina to have "significant historical basis" and the injury alleged "could deprive it of a meaningful political choice." Id. at 401. Although Justice Stevens felt the State's claim lacked merit, he observed that "[a]s a practical matter, this requirement will force South Carolina to issue its bonds in registered form." Id. at 404.

On June 22, 1984, the National Governors' Association filed a motion for leave to intervene as Plaintiff. The Court referred the motion to the Special Master, who granted it on November 16, 1984.

A majority of the States filed amicus curiae briefs on behalf of the Plaintiff South Carolina as did the Government Finance

Officers Association, The National Institute of Municipal Law Officers, The Council of State Governments, National Association of Counties, National Conference of State Legislatures, National League of Cities, States Conference of Mayors, International City Management Association, and Public Securities Association.

Following a period of discovery, the Master heard testimony of various witnesses and oral arguments of counsel. The Master issued a report setting forth his factual findings and legal analysis. The Master acknowledged that his "report and recommendations are purely advisory. The Court itself will determine to grant or deny the ultimate relief sought. See R. Stern, E. Gressman, and S. Shapiro, Supreme Court Practice at 495 (6th Ed. 1986)." Report at 6. He concluded the Plaintiff South Carolina and the recommended Plaintiff-In-Intervention National Governors' Association

were not entitled to relief and recommended judgment to the Defendant.

EXCEPTIONS

1. The Plaintiff excepts to the Special Master's finding that municipal issuers have raised no serious challenge to the constitutionality of Congress' previous decisions to regulate industrial development and arbitrage bonds. The Master's finding is irrelevant, beyond the issues raised in the pleadings, and to the extent it is a finding to support the Plaintiff's acquiescence in the field of congressional regulation of the Plaintiff's taxing authority or to estopp the Plaintiff in this action, it is unsupported by the record.

2. The Plaintiff excepts to the Special Master's finding that Congress was presented with competent proof that bearer bonds posed a tax compliance problem which

is substantially reduced by the challenged registration requirements and that the registration is necessary to achieve the congressional objective.

3. The Plaintiff excepts to the Special Master's finding that opposition to the registration requirement and the penalty of subjecting the states' bonds to a tax was not a priority matter with the Plaintiff.

4. The Plaintiff excepts to the Special Master's finding that the municipal bond market in all probability would have moved to a registered book entry system on its own even if TEFRA had not been enacted.

5. The Plaintiff excepts to the Special Master's finding that the rate of increase

in borrowing has not been slowed by the challenged statute.

6. The Plaintiff excepts to the Special Master's finding that the registration requirement applies to the form and not the substance of the Plaintiff's bond issues.

7. The Plaintiff excepts to the Special Master's finding that the form of bond issues has little intrinsic value to the states.

8. The Plaintiff excepts to the Special Master's finding that the increased cost and burden of registration is not so onerous as to interfere with the operation of local governments.

9. The Plaintiff excepts to the Special Master's finding that the Plaintiff failed to prove investor preference for bearer municipal bonds.

10. The Plaintiff excepts to the Special Master's finding that there was no interest rate differential between bearer and registered bonds.

11. The Plaintiff excepts to the Special Master's finding that Congress' conclusion that registration may facilitate tax avoidance and income concealment "seem altogether reasonable."

12. The Plaintiff excepts to the Special Master's finding tnat the registration requirement has not had any substantive effect on the ability of the states and localities to raise debt capital.

13. The Plaintiff excepts to the Special Master's finding that TEFRA has had no effect on the political processes by which a state decides to issue debt.

14. The Plaintiff excepts to the Special Master's finding that TEFRA has not changed how much the states borrow, for what purposes they borrow, how they decide to borrow, or other important aspects of the borrowing process.

15. The Plaintiff excepts to the Special Master's failure to define the scope of judicial inquiry concerning whether the registration requirement was necessary to achieve a legitimate purpose.

16. The Plaintiff excepts to the Special Master's finding that the testimony supports the belief that a "not

insubstantial number of investors prefer bearer bonds because they facilitate tax evasion and concealment of illegal income," the error being there was no competent proof to support such a finding.

17. The Plaintiff excepts to the Special Master's finding that "seemingly the states accepted federal regulations dealing with arbitrage and industrial development bonds as the price of their ability to minimize their own interest costs."

18. The Plaintiff excepts to the Special Master's finding that the history of state acquiescence weakens the states' contention that requiring registration is destructive of their sovereignty and that the political process failed to perform as intended.

19. The Plaintiff excepts to the Special Master's finding that the registration requirement was non-discriminatory.

20. The Plaintiff excepts to the Special Master's conclusion that the tax sanction of TEFRA registration does not violate the doctrine of intergovernmental tax immunity.

21. The Plaintiff excepts to the Special Master's conclusion that the tax sanction of TEFRA's registration requirement does not violate the Tenth Amendment.

22. The Plaintiff excepts to the Special Master's conclusion that the tax sanction of TEFRA's registration requirement does not violate our notions of Federalism.

23. The Plaintiff excepts to the Special Master's conclusion that the tax sanction of TEFRA's registration requirement does not violate the Sixteenth Amendment.

24. The Plaintiff excepts to the Special Master's conclusion that the sponsors of the Sixteenth Amendment did not contemplate incorporating intergovernmental tax immunity, the error being the question is whether the states in ratifying the Sixteenth Amendment understood the states' tax immunity would be preserved in the Sixteenth Amendment.

25. The Plaintiff excepts to the Special Master's conclusion that the tax sanction is not an impermissible regulatory tax.

26. The Plaintiff excepts to the Special Master's conclusion that the compliance

burdens of TEFRA do not constitute an impermissible tax.

27. The Plaintiff excepts to the Special Master's conclusion that the tax sanction does not burden the states' borrowing power.

28. The Plaintiff excepts to the Special Master's conclusion that the tax sanction does not violate the states' political process.

SUMMARY OF ARGUMENT

1. Application of the penalty provision of §103 offends the doctrine of reciprocal tax immunity recognized by Alexander Hamilton and the Drafters of the Constitution, Chief Justice Marshall in M'Culloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819), and this Court's explicit holding in Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895). Further, the assertion of the taxing power by the National Government upon state bond proceeds is itself an unconstitutional abuse.

2. The states ratified the Sixteenth Amendment upon the understanding that the National Government could not tax the proceeds of state bond issues used to finance the operations of state government. Intergovernmental tax immunity, embodied in the precise holding of this Court in Pollock -- an income tax upon the proceeds of state bonds issued to finance state governmental operations is an

indirect tax upon the state and repugnant to the reserve powers of the state -- was incorporated into the Sixteenth Amendment. Thus, application of §103 violates the Sixteenth Amendment.

3. The Tenth Amendment reserves to the states powers not delegated to the national government, and "unquestionably" preserves unto to the states "a significant measure of sovereign authority." Garcia v. San Antonio Metropolitan Transit Authority, 469 U.S. 528, ___, 105 S. Ct. 1005, 1017 (1985) (quoting from EEOC v. Wyoming, 460 U.S. 226, 269 (1983) (Powell, J., dissenting)). The ability to exercise freely the right to borrow money to fund core state governmental operations is an essential aspect of state sovereignty. A tax upon the income of state obligations is an indirect tax upon something Congress has no right to tax. The tax is no less repugnant to the Constitution merely because Congress

permits tax immunity if the state issues its debt upon conditions acceptable to Congress. If Congress can legislate conditions for tax immunity, the states enjoy not a tax immunity, but a tax exemption issued at the prerogative of Congress.

4. The State has a protected right under its reserve powers expressed in the Tenth Amendment and embraced in our notion of Federalism and in the Sixteenth Amendment to issue debt instruments without subjecting its bond proceeds to federal taxation. Congress does not bestow this right upon the State; and it cannot condition its free exercise upon onerous penalties which make its free exercise a hollow right. The Tenth Amendment, as part of the Bill of Rights, affords the State protection of its sovereignty. As such, this Amendment parallels the protection of personal liberties embraced in earlier amendments. Congress' attempt to shackle the State's

exercise of its sovereignty by exacting a penalty deprives the State of its sovereignty and is repugnant to the Constitution, in the same way that deprivations of free exercise of speech, religion or other rights in the Bill of Rights are effected by imposing conditions and penalties.

5. This Court is asked by the National Government to sanction its intrusion into an essential exercise of state sovereignty upon the premise that the intrusion is limited and even-handed and that modern national problems require flexible responses. The intrusion is discriminatory and the regulation unnecessary to achieve its objectives. Moreover, the National Government's position is no more than that of an offer of the forbidden fruit. History teaches us to respect and fear the human tendency to concentrate power. An acute appreciation of the tendency to centralize authority inspired the Constitutional Framers

to adopt the Bill of Rights for the precise purpose of thwarting that tendency.

6. Congress has attempted to dominate the states through its interpretation of the Sixteenth Amendment to limit the states' tax immunity, and its inherent competition with the states to raise revenue independently. The political procedural safeguards of the Constitution discussed in Garcia, 469 U.S. at ___, 105 S. Ct. at 1018-19, are inadequate to protect the states. Recent political debate makes clear the National Government wishes to assert its ability to tax the proceeds of state bond issues and restrict the amount of state debt which may be issued "tax exempt by Congress." Congress has enacted a so-called minimum tax which includes within the definition of income the interest on state bonds. Social Security Amendments of 1983, Pub. L. No. 98-21, §121, 97 Stat. 65. In The Tax Reform Act of 1986, P.L. 99-518, the

National Government asserts the authority to tell the states how much debt they may issue exempt from federal taxation and for what purposes the debt may be issued tax- exempt. The Court's admonition in United States v. Baltimore & Ohio Railroad Co., 84 U.S. (17 Wall.) 322, (1872) rings true:

> If they may be taxed lightly, they may be taxed heavily; if justly, oppressively. Their operation may be impeded and may be destroyed if any interference is permitted. Hence, the beginning of such taxation is not allowed on the one side, is not claimed on the other.

Id. at 327-28.

7. When the National Government exercises its taxing power, Garcia and cases interpreting Congress' power under the commerce clause are not analogous. Congress, if it so desires, can allocate to itself exclusive authority to regulate interstate commerce. However, the power to tax is neither the

exclusive domain of the states nor the federal government.

8. The danger the states face from the National Government is not obliteration. Rather, it lies in the "tyranny of small decisions" which rob the states of their independence and ultimately reduces them to meaningless administrative arms of the National Government. Our notion of Federalism commands respect for the states. "It is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country." New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting). The roots of Federalism are based on the recognition that the people are the ultimate source of sovereignty; they can best exercise that authority in the state houses, county courthouses and city halls

scattered throughout the country. Section 103 impinges upon the authority of the states and their people to exercise sovereign state powers.

9. As a basis for upholding the penalty imposed by §103(j) of TEFRA, the Master concluded that other regulations enacted by the National Government relating to industrial development bonds and arbitrage bonds are more intrusive upon the exercise of the State's sovereignty, and had not been challenged by the states. Apparently, the Master believes the State of South Carolina has relinquished its sovereignty and its right to timely challenge the current statute. If the Master's analysis of acquiescence or estoppel to assert constitutionally protected rights is correct, a multitude of citizens protected by constitutional provisions against racial discrimination and voting rights would be barred from relief in federal court. The

Master's premise that the State forfeits its sovereignty unless it challenges all legislation impinging upon that sovereignty would necessitate litigation simply to preserve sovereignty, even if the state had not disagreed with the judgment exercised by the National Government in enacting certain regulations.

10. The Master's reliance upon the State's failure to challenge industrial development bond regulations and arbitrage bond regulations is misplaced. Whether taxation of so-called private activity development bonds or arbitrage provision is cognizable under the Pollock test, the Tenth or Sixteenth Amendments call for an inquiry beyond the issues presented by the pleadings. Finally, the Master's intrigue with the inferences to be drawn by the lack of litigation concerning challenges to other statutes regulating tax exemptions fails to appreciate the procedural hurdles to

litigation. Indeed, the National Government began its resistance to consideration of the merits in the pending action by claiming lack of authority of even this Court to entertain the action. South Carolina v. Regan, 465 U.S. 367 (1984).

ARGUMENT

I. SECTION 310 (b) (1) OF THE ACT VIOLATES THE UNITED STATES CONSTITUTION BY SUBJECTING THE INTEREST PAID ON DEBT OBLIGATIONS ISSUED BY SOUTH CAROLINA TO FEDERAL INCOME TAXATION.

Imposition of a tax pursuant to Section 310 as a penalty violates the doctrine of intergovernmental tax immunity and the teaching of Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, vacated on other grounds on reh'g, 158 U.S. 601 (1895). Ratification of the Sixteenth Amendment was accomplished upon the states' understanding that the protection against federal taxation of state bond proceeds was incorporated into the Sixteenth Amendment. In order for the Court to evaluate the application of the intergovernmental tax immunity doctrine, the incoporation of that doctrine into the Sixteenth Amendment and the issue of whether Congress may condition state immunity from taxation upon restrictions

relating to the states' right to freely borrow for their operations, in this brief South Carolina reviews applicable declarations contemporaneous with the adoption of the Constitution describing the permissible relationships between the national and state governments, decisions of this Court concerning intergovernmental tax immunity, the history of the adoption of Amendment Sixteen, and decisions of this Court defining the limits of intergovernmental tax immunity since the adoption of Amendment Sixteen.

A. Eighteenth Century Declarations by Drafters of United States Constitution.

> Money is, with propriety, considered as the vital principle of the body politic; as that which sustains its life and motion and enables it to perform its most essential functions. A complete power, therefore, to procure a regular and adequate supply of revenue, as far as the resources of the community will permit, may be regarded as an indispensable ingredient in every constitution. From a

> deficiency in this particular, one of two evils must ensue; either the people must be subjected to continual plunder, as a substitute for a more eligible mode of supplying the public wants, or the government must sink into a fatal atrophy, and, in a short course of time, perish.

THE FEDERALIST No. 30, at 188 (A. Hamilton) (Mentor ed. 1961).

Alexander Hamilton wrote these words to urge the adoption of the United States Constitution. The source of the Confederation's revenues was limited by the Articles of Confederation to requisitions from the states. Id.

Speaking for the drafting convention, Hamilton defended the concurrent revenue-raising powers of the national government and of the states, stating:

> The convention thought the concurrent jurisdiction preferable to that subordination; and it is evident that it has at least the merit of reconciling an indefinite constitutional power of taxation in the federal government with an adequate and independent power in the

> States to provide for their own necessities. . . .

Id. No. 34, at 211 (A. Hamilton).

He was aware of the possibility of friction between the two governments, each with a sovereign revenue-raising power:

> The particular policy of the national and of the State systems of finance might now and then not exactly coincide, and might require reciprocal forbearances. It is not, however, a mere possibility of inconvenience in the exercise of powers, but an immediate constitutional repugnancy that can by implication alienate and extinguish a pre-existing right of sovereignty.

Id. No. 32, at 200 (A. Hamilton) (emphasis added).

Hamilton recognized that the national and state governments would exercise their revenue-raising powers primarily through taxation and through borrowing. The unfettered exercise of both types of revenue-raising measures was essential.

B. Nineteenth Century Judicial Decisions.

In M'Culloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819), the Court held that Maryland had no authority to tax a bank chartered by Congress. Chief Justice Marshall enunciated the oft-quoted principle "[t]hat the power to tax involves the power to destroy." Id. Maryland's taxing power had to be measured by the extent of sovereignty that the people of Maryland possessed and could confer on their government; accordingly, Maryland could not tax what it could not exercise sovereignty over. By adopting that principle, the Chief Justice declared:

> We are not driven to the perplexing inquiry, so unfit for the judicial department, what degree of taxation is the legitimate use, and what degree may amount to the abuse of the power. The attempt to use it on the means employed by the government of the Union, in pursuance of the constitution, is itself an abuse, because it is a usurpation

> which the people of a single state cannot give.

Id. at 430 (emphasis added).

Weston v. The City Council of Charleston, 27 U.S. (2 Pet.) 481 (1829), was the first decision expressly holding that a tax imposed by one sovereign on the obligations or securities of the other is unconstitutional. Again Chief Justice Marshall, speaking for a majority of the Court, invalidated the Charleston ordinance imposing a tax on the stock of the United States for the repayment of loans:

> Congress has power "to borrow money on the credit of the United States." The stock it issues is the evidence of a debt created by the exercise of this power. The tax in question is a tax upon the contract subsisting between the government and the individual. It bears directly upon that contract, while subsisting and in full force. The power operates upon the contract the instant it is framed, and must imply a right to affect that contract.
>
> . . .
>
> If the right to impose the tax exists, it is a right which in its

> nature acknowledges no limits. It may be carried to any extent within the jurisdiction of the State or corporation which imposes it, which the will of each State and corporation may prescribe.

Id. at 465-66 (emphasis added).

Marshall reiterated the M'Culloch principle: the extent of a state's taxing power is measured by the extent of its sovereignty. Thus, a contract made by the national government in the exercise of its delegated borrowing power "is undoubtedly independent of the will of any State in which the individual who lends may reside." Id. at 467.

Charleston contended a direct attempt to oppose the national government's borrowing power such as an ordinance prohibiting loans to the United States would be invalid, but an attempt which may merely "consequentially affect it," id., was allowable. Marshall declared:

> It is not the want of original power in an independent sovereign State, to prohibit loans to a foreign government, which restrains the Legislature from direct opposition to those made by the United States. The restraint is imposed by our Constitution....
>
> The right to tax the contract to any extent, when made, must operate upon the power to borrow before it is exercised, and have a sensible influence on the contract. The extent of this influence depends on the will of a distinct government. To any extent, however inconsiderable, it is a burden on the operations of government. It may be carried to an extent which shall arrest them entirely.

Id. at 468 (emphasis added).

Perhaps most significant to South Carolina's challenge to the TEFRA penalty tax is the Chief Justice's discussion of the difference between the tax Charleston sought to impose on United States stocks issued for loan repayments and a tax on lands sold by the United States:

> It is admitted by the counsel for the defendants, that the power to tax stock must affect the terms on which loans will be made; but this

> objection, it is said, has no more weight when urged against the application of an acknowledged power to government stock, than if urged against its application to lands sold by the United States.
>
> The distinction is, we think, apparent. When lands are sold no connection remains between the purchaser and the government. The lands purchased become a part of the mass of property in the country with no implied exemption from common burdens. All lands are derived from the general or particular government, and all lands are subject to taxation. Lands sold are in the condition of money borrowed and repaid. Its liability to taxation in any form it may then assumed is not questioned. The connection between the borrower and the lender is dissolved. It is no burden on loans, it is no impediment to the power of borrowing, that the money, when repaid, loses its exemption from taxation. But a tax upon debts due from the government, stands, we think, on very different principles from a tax on lands which the government has sold.

Id. at 468-69 (emphasis added).

Finally, countering Charleston's assertion that a tax on stock came within the M'Culloch exceptions, the Chief Justice concluded:

> We do not think so. The Bank of the United States is an instrument essential to the fiscal operations of the government, and the power which might be exercised to its destruction was denied. But property acquired by that corporation in a State was supposed to be placed in the same condition with property acquired by an individual.
>
> The tax on government stock is thought by this court to be a tax on the contract, a tax on the power to borrow money on the credit of the United States, and consequently to be repugnant to the Constitution.

Id. at 469 (emphasis added).

Decisions uniformly invalidated the national government's attempt to tax the property or revenues of the states United States v. Railroad Company, 84 U.S. (17 Wall.) 322 (1872), to tax the salaries of state government officials, Collector v. Day, 78 U.S. (11 Wall.) 113 (1871); and the states' attempt to tax the salaries of United States employees. Dobbins v. Commissioners of Erie County, 41 U.S. (16 Pet.) 435 (1842).

These discussions recognized inherent sovereignty between the state and national government which must be respected. The Court was guided by the principle that:

> If they may be taxed lightly, they may be taxed heavily; if justly, oppressively. Their operation may be impeded and may be destroyed if any interference is permitted. Hence, the beginning of such taxation is not allowed on the one side, is not claimed on the other.

84 U.S. at 327-28.

C. The Pollock Decision

In Pollock the Court reviewed the constitutionality of a provision of the Revenue Act of 1894 which imposed a tax on the interest paid on State obligations. The Court concluded:

> The law under consideration provides "that nothing herein contained shall apply to states, counties or municipalities." It is contended that, although the property or revenues of the states or their instrumentalities cannot be taxed, nevertheless the income derived from

state, county, and municipal securities can be taxed. But we think the same want of power to tax the property or revenues of the states or their instrumentalities exists in relation to a tax on the income from their securities, and for the same reason; and that reason is given by Chief Justice Marshall, in Weston v. City Council, 2 Pet. 449, 468, where he said: "The right to tax the contract to any extent, when made, must operate upon the power to borrow before it is exercised, and have a sensible influence on the contract. The extent of this influence depends on the will of a distinct government. To any extent, however inconsiderable, it is a burthen on the operations of government. It may be carried to an extent which shall arrest them entirely. * * * The tax on government stock is thought by this court to be a tax on the contract, a tax on the power to borrow money on the credit of the United States, and consequently to be repugnant to the constitution." Applying this language to these municipal securities, it is obvious that taxation on the interest therefrom would operate on the power to borrow before it is exercised, and would have a sensible influence on the contract, and that the tax in question is a tax on the power of the states and their instrumentalities to borrow money, and consequently repugnant to the constitution.

157 U.S. at 585-586 (emphasis added).

Justice Field concurred: "[t]hese bonds and securities are as important to the performance of the duties of the state as like bonds and securities of the United States are important to the performance of their duties, and are as exempt from ..., taxation...." Id. at 601. Justice Field quoted Judge Cooley from The Principles of Constitutional Law that "[t]he constitution contemplates no such shackles upon state powers, and by implication forbids them." Id. at 602 (emphasis added).

While there were dissents as to other portions of the Court's holdings, the dissenters agreed with the majority on the issue of the tax-exempt nature of State obligations. Id. at 651 (White, J., dissenting); Id. at 654 (Harlan, J., dissenting). "[I]t is immaterial to inquire whether the tax is, in its nature or by its operation, a direct or an indirect tax; for the

instrumentalities of the states ... are not subjects of national taxation in any form or for any purpose.... Id.

The holding of Pollock was that:

> We have unanimously held in this case that, so far as this law operates on the receipts from municipal bonds, it cannot be sustained, because it is a tax on the power of the states and on their instrumentalities to borrow money, and consequently repugnant to the constitution.

158 U.S. 601, 630.

Likewise, the statement of Justice Brown, in dissent:

> The tax upon the income of municipal bonds falls obviously within the other category, -- of an indirect tax upon something which congress has no right to tax at all, -- and hence is invalid.

Id. at 693.

The bedrock of the Constitution melded the reciprocal tax immunity doctrine adopted in Pollock: (1) an unrestricted revenue-raising power was essential to the creation and

continued existence of the national government; (2) an equally complete revenue-raising power was necessary to maintain the states' sovereignty; (3) the national and state systems of finance might not always coincide and the co-equal nature of the revenue-raising power would necessitate reciprocal restraints when friction occurred; and (4) the borrowing power and the revenue-raising power were essential.

In recognition of the constitutionally mandated relationship between the national and State government, the court had concluded: (1) the complete revenue-raising power vested in both the national and the state governments meant that neither sovereign could tax the other; (2) interest paid on obligations issued by the sovereign was included in the reciprocal tax immunity as a tax on the contract between the borrower and the lender; and (3) one sovereign's attempt, without more, to impose a tax on the interest paid on the other's

obligations violated the reciprocal tax immunity doctrine; because the assertion of the taxing power by the one was itself an unconstitutional burden on the other.

D. Adoption of the Sixteenth Amendment.

In addition to declaring income on state bond issues immune from federal taxation, in Pollock the Court found the apportionment of income taxes between the states unconstitutional. President Taft urged Congress to adopt the Sixteenth Amendment since "(f)or the Congress to assume that the (Supreme) (C)ourt will reverse itself, and to enact legislation on such an assumption will not strengthen popular confidence in the stability of judicial construction of the Constitution." 44 Cong. Rec. 1548, 1568-69, 3377 (1909).

Amendment Sixteen provides:

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration. (emphasis supplied)

Congress adopted the proposal. The proposal to tax income "from whatever source derived" ignited an intense political debate in the ratification process. Governor Charles Evans Hughes of New York favored the apportionment provision, but assailed the phrase "from whatever source derived" claiming it may include "income derived from State and municipal securities." He cautioned that ratification of an amendment to the Constitution is "the most important of political acts," Appendix A to Plaintiff's Brief, and assent should not be given upon the basis the National government will apply a sound rule of construction. Hughes was particularly concerned that the amendment "will

be in effect a grant to the Federal government of the power which [it] defines." Id.

Amendment supporters in Congress decried Hughes' criticism as "unfounded and alarmist." 1/ Congressional and public debate ensued concerning the irrefutable logic and dogma of Pollock which immunized the income of state bond proceeds from federal taxation. Thereafter, the amendment was ratified by the required three-fourths of the states. The legislative history makes clear the assent by the states was materially induced by recognition that the amendment embodied the Pollock decision. Id.

The Special Master opined: "...[T]he principal sponsors of the Sixteenth Amendment took pains to assure the Congress that passage of the Sixteenth Amendment would not, in and of

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1/ Amicus curiae brief of the Government Finance Officers Association contains a comprehensive discussion of the adoption of the Amendment.

itself, authorize federal taxation of municipal bonds." Report at 163 n. 463.

E. Twentieth Century Judicial Decisions.

In Brushaber v. Union Pacific Railroad Co., 240 U.S. 1 (1916), the Court rejected the claim that the Sixteenth Amendment broadened the sources of income which could be constitutionally taxed by the United States. After reviewing the history of the ratification of the Sixteenth Amendment and its relation to Pollock, id. at 12-17, the Court concluded that the Sixteenth Amendment did not have the effect of expanding the federal taxing power and

> that the whole purpose of the Amendment was to relieve all income taxes when imposed from apportionment from a consideration of the source whence the income was derived . . . . [It was] not to change the existing interpretation except to the extent necessary to accomplish the result intended (emphasis supplied).

Id. at 17-18; see also Stanton v. Baltic Mining Co., 240 U.S. 103, 112 (1916); Evans v. Gore, 253 U.S. 245, 260-64 (1920).

In more than one hundred years since Pollock the Court has decided several cases involving reciprocal tax immunity. In not one of those cases, however, has Pollock been questioned either expressly or by implication until the dissent of Justice Stevens here. South Carolina v. Regan, 465 U.S. 367, 399-406 (1984). The doctrine of stare decisis is not rigidly applied to constitutional questions, but "any departure from the doctrine of stare decisis demands special justification." Arizona v. Rumsey, 467 U.S. 203, 2112 (1984); see also Oregon v. Kennedy, 456 U.S. 667, 691-92 n. 34 (Stevens, J., concurring); Garcia v. San Antonio Metro Transit Authority, 469 U.S. ___, 105 S. Ct. at 1022 (Powell, J., dissenting).

Several post Pollock decisions have held the doctrine of tax immunity inapplicable to subsequent Congressional enactments. None involves the basic fiscal and revenue power of the state. Each offers rationale without disavowing the constitutional basis upon which Pollock was premised. When the state functions as an economic competitor in the arena of commerce, either as a contractor, lessor, or employer or when taxation of bonds does not relate to the initial bond contract between the state and purchaser, but the subsequent sale, gift or inheritance of the bond and the bond has become an item of commerce, state immunity from federal taxation is generally not applicable.

In 1926, the Court held that the United States could tax the income received by an independent contractor from a contract with a state. Metcalf & Eddy v. Mitchell, 269 U.S. 514 (1926) Citing Weston and Pollock, the Court declared:

> But this court has repeatedly held that those agencies through which either government immediately and directly exercises its sovereign powers, are immune from the taxing power of the other. Thus. . ., its obligations sold to raise public funds. . ., are. . . so intimately connected with the necessary functions of government, as to fall within the established exemption; and when the instrumentality is of that character, the immunity extends not only to the instrumentality itself but to income derived from it. . . .

Id. at 522.

The Court concluded an independent contractor used his property or derived profits in dealings with the government but was not "an instrumentality of government within the [tax immunity] rule." Id. at 523. Taxing an independent contractor's earnings from government contracts did not impair the ability of the State to procure the services of private individuals. Id. at 526. The Court continued to recognize the existence of functions altogether beyond the taxing power:

> While it is evident that in one aspect the extent of the exemption must finally depend upon the effect of the tax upon the functions of the government alleged to be affected by it, still the nature of the governmental agencies or the mode of their constitution may not be disregarded in passing on the question of tax exemption; for it is obvious that an agency may be of such a character or so intimately connected with the exercise of a power or the performance of a duty by the one government, that any taxation of it by the other would be such a direct interference with the functions of government itself as to be plainly beyond the taxing power.
>
> It is on this principle that, as we have seen, any taxation by one government of . . . the public securities of the other. . . is prohibited.

Id. at 524 (citation omitted and emphasis added).

In Willcuts v. Bunn, 282 U.S. 216 (1931), the Court upheld a capital gains tax imposed by the United States on gains from sales of municipal bonds. After reviewing Pollock with approval, the Court differentiated the capital gains tax from a tax on interest from those bonds:

> The sale of the bonds by their owners, after they have been issued by the State or municipality, is a transaction distinct from the contracts made by the government in the bonds themselves, and the profits on such sales are in a different category of income from that of the interest payable on the bonds.... The tax upon interest is levied upon the return which comes to the owner of the security according to the provisions of the obligation and without any further transaction on his part. The tax falls upon the owner by virtue of the mere fact of ownership, regardless of use or disposition of the security. The tax upon profits made upon purchases and sales is an excise upon the result of the combination of several factors, including capital investment and, quite generally, some measure of sagacity....

Id. at 226-28.

In James v. Dravo Contracting Co., 302 U.S. 134 (1937), the Court made the Metcalf & Eddy holding reciprocal by sustaining a state tax on the income of an independent contractor of the United States. The Court continued to accept Pollock:

> There is no ineluctable logic which makes the doctrine of immunity with respect to government bonds applicable to the earnings of an independent contractor rendering services to the government. That doctrine recognizes the direct effect of a tax which "would operate on the power to borrow before it is exercised" (Pollock v. Farmers' Loan & Trust Co., supra), and which would directly affect the government's obligation as a continuing security. Vital considerations are there involved respecting the permanent relations of the government to investors in its securities and its ability to maintain its credit; considerations which are not found in connection with contracts made from time to time for the services of independent contractors.

Id. at 152-53.

In dissent, Justice Roberts characterized the reciprocal tax immunity cases beginning with M'Culloch. "Chief Justice Marshall denied the existence of the power. From that day to this the court has consistently held that the question is not one of quantum, not one of the weight of the burden, but one of power. . . . Id. at 181 (emphasis added).

In Helvering v. Mountain Producers Corp., 303 U.S. 376 (1938), the Court upheld the United States tax on a corporation's income from property it leased from a state. It noted Pollock involved a tax on the interest paid on state obligations -- a tax "bearing directly upon the exercise of the borrowing power of the government" -- and not a capital gains tax a tax on "a transaction distinct from the contracts made by the government in the bonds themselves." Id. at 386.

The same year, in Helvering v. Gerhardt, 304 U.S. 405 (1938), the Court sustained a federal tax on the salaries of state employees. Again, it distinguished the tax from one imposed on a function "essential to the maintenance of a state government: as where the attempt was. . . to tax income received by a private investor from state bonds, and thus threaten impairment of the borrowing power. . . ." Id. at 417.

The Court enunciated two principles of limitation to hold the states' tax immunity to its proper function: first, excluded from tax immunity are activities thought not to be essential to the preservation of state government; and, second, excluded from tax immunity are those taxes laid on individuals where the burden on the state is speculative and uncertain. Id. at 419-20.

Graves v. New York ex rel. O'Keefe, 306 U.S. 466 (1939), made Gerhardt reciprocal by upholding a state tax on the income of United States employees. The "single" question decided was whether a state tax on the salary of an employee of a United States corporation (Home Owners' Loan Corporation) imposed an unconstitutional burden on the national government. Id. at 477. Weston and Pollock were not mentioned in the majority opinion.

In New York v. United States, 326 U.S. 572 (1946), the Court upheld a United States tax on

New York's mineral water sales, finding that New York was not immune from a non-discriminatory federal excise tax. The decision was a splintered one, but, as Justice Rutledge observed, "[a]ll agree that not all of the former immunity is gone." Id. at 584. Justice Frankfurter's majority opinion favored a restrictive tax immunity, allowing it only if the tax imposed discriminated against the state. He recognized an irreducible core of tax immunity:

> There are, of course, State activities and State-owned property that partake of uniqueness from the point of view of intergovernmental relations. These inherently constitute a class by themselves. Only a State can own a Statehouse; only a State can get income by taxing. These could not be included for purposes of federal taxation in any abstract category of taxpayers without taxing the State as a State.

Id. at 582.

The two dissenters -- Justices Douglas and Black -- expressly referred to the issuance of

debt obligations as protected by the tax immunity doctrine. Id. at 591, 593, 595. They argued "[t]he Constitution is a compact between sovereigns. The power of one sovereign to tax another is an innovation so startling as to require explicit authority if it is to be allowed." Id. at 595 (emphasis added).

In Massachusetts v. United States, 435 U.S. 444 (1978), the Court determined that a federal flat-fee registration tax (amounting to $131.43 in 1973) on state aircraft was in the nature of a user fee. 2/ Without discussing the more recent decisions' treatment of Weston and Pollock, the Court concluded the more recent decisions produced a "practical construction" of the tax immunity doctrine: neither the taxing power of the government

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2/ Justice Brennan's tax immunity discussion was joined by a plurality; the concurring and dissenting opinions felt the discussion on tax immunity was unnecessary because of the user fee holding. 435 U.S. at 471-72 (Rehnquist, J., dissenting).

imposing the tax nor the "appropriate exercise of the functions of the government affected by it" can be impaired. Id. at 459 (quoting from New York v. United States, 326 U.S. at 589-90) (emphasis added). A tax is valid if the subject of the tax is a "natural and traditional source of federal revenue" and if it is "inconceivable" that the tax could "ever" operate to preclude traditional state activities. Id. at 459-60.

The Court reminded us that "the existence of the States implies some restriction on the national taxing power." Id. at 454. Further the Court quoted from New York v. United States that "limitation [on state sovereignty] cannot be so varied or extended as seriously to impair. . . the appropriate exercise of the functions of the government affected by it." Id. at 459.

F. Section 103 offends the test articulated in New York v. United States and Massachusetts v. United States

If the test enunciated in New York v. United States and in Massachusetts v. United States applies here, Section 310(b)(1) fails that test. The tax immunity for interest paid on state obligations does not withdraw a traditional source of revenue from the United States. Section 310(b)(1) also imposes a tax on states discriminatory in its impact. Both private issuers and the United States had already chosen to issue registered bonds before the enactment of Section 310 (b)(1). States and their instrumentalities were the only issuers forced by Section 310(b)(1)'s sanction to issue registered bonds.

The pending action is the first case since Pollock directly involving an attempt by the National Government to tax the interest paid by a state to the purchaser of its bond. Although

the doctrine has been refined, Weston and Pollock remain intact. Indeed, the Court expressly cited Weston with approval as recently as 1983 in American Bank and Trust Co. v. Dallas County, 463 U.S. 855, 870 (1983); see also First National Bank of Atlanta v. Bartow County Board of Tax Assessors, 105 S. Ct. 1516, 1522 (1985); cf. Pennhurst State School v. Halderman, 451 U.S. 1, 17 n. 13 (1981) ("There are limits on the power of Congress to impose conditions on the States pursuant to its spending power.")

The constitutional principles which inspired Pollock remain unchanged: (1) the revenue-raising power is vital to the continued existence of both the national and the state governments; (2) the national and state systems of finance have not always coincided and the co-equal nature of the revenue-raising power has necessitated reciprocal restraints when

friction has occurred; and (3) the borrowing power is as essential to the revenue-raising power as the taxing power.

Non-discriminatory user fee taxes upon the property of the state and taxation of income of employees of the state or federal government or independent contractors is permitted as not invading the essential attributes of state or federal sovereignty.

However, Federalism proscribes certain conduct: (1) the revenue-raising power vested in both sovereigns means that neither can directly tax the other; (2) a tax on interest paid on obligations issued by either government, as a tax on the contract between the borrower and the lender, directly taxes the issuer; and (3) the inability of either sovereign to tax the interest paid on obligations issued by the other results from the lack of power (or sovereignty) in that respect; for that reason, the attempt, without

more, by either sovereign to use such a taxing power burdens the other.

G. Effect of Section 310(b)(1) on reciprocal tax immunity doctrine.

By subjecting the interest paid on state obligations which are not in registered form to federal income taxation, Section 310(b)(1) has effectively precluded the states and their instrumentalities from issuing non-registered obligations. Justice Stevens in his dissent to the earlier opinion in this case observed: "As a practical matter, this requirement will force South Carolina to issue its bonds in registered form." 465 U.S. at 404. The taxation sanction is so severe that states are no longer able to issue their obligations in bearer form, the form they have preferred from the beginning. The record establishes that no bearer bonds have been issued since the effective date of the registration requirement. Report at 34.

That Section 310(b)(1)'s sanction has precluded the states and their instrumentalities from issuing taxable bearer bonds, however, does not alter its status as a tax. It is a tax that, because of its severity, will never be collected but it is nonetheless a tax. Indeed, Section 310(b)(1)'s "power to tax involves the power to destroy" the states' ability to issue bearer bonds. And because, as the Court has held since at least Weston, it operates directly on the states' borrowing power, it is a tax that the National Government is without authority to impose.

The increased costs (especially incurred by small issuers) as well as the higher interest rates caused by the registration requirement themselves work as a tax on the state issuer because the state issuer directly incurs them. While higher costs do not by themselves ordinarily constitute a tax, they do constitute a tax when they are incurred because

the alternative is an explicit tax so severe that it forces the issuer to comply.

H. Section 103 taxes the State as a penalty when It exercises Its Constitutional rights.

Enforcement of the registration requirement is achieved by imposing a tax for non-enforcement -- that is, Section 310(b)(1) directs the states and their instrumentalities to issue registered bonds or forfeit their immunity. The United States Congress, like all legislatures, cannot do by indirection what it cannot do directly. See Maxwell v. Bugbee, 250 U.S. 525, 543-44 (1919) (Holmes, J., dissenting).

The State has a constitutionally protected right under its reserved powers expressed in the Tenth Amendment embraced in our notion of Federalism and the Sixteenth Amendment to issue debt instruments without subjecting its bond

proceeds to taxation. Congress does not bestow this right upon the state; and it cannot condition its free exercise upon onerous penalties which make its free exercise a hollow right.

The Tenth Amendment is part of the Bill of Rights. It affords the State protection of its sovereignty which parallels the protection of personal liberties embraced in earlier amendments. Congress' attempt to condition South Carolina's right to the unfettered exercise of its sovereignty by exacting a penalty is repugnant to the Constitution, just as is a congressional attempt to deter the free exercise of speech or religion by imposing conditions and penalties. See Sherbert v. Verner, 374 U.S. 398, 404 (1963) (exclusion from unemployment benefits because plaintiff refused to work on Saturdays, due to her religion, was unconstitutional because governmental imposition of a choice between

adhering to religious beliefs and obtaining state benefits interferes with the free exercise of religion as would a fine imposed for Saturday worship); Elrod v. Burns, 427 U.S. 347, 360-61 (1976) (termination of public employees based on political affiliation violated the First Amendment by imposing an unconditional condition on the receipt of a public benefit); cf. Speiser v. Randall, 357 U.S. 513, 518 (1958) ("It cannot be gainsaid that a discriminatory denial of a tax exemption for engaging in speech is a limitation on free speech.").

The penalty Congress imposes upon the State is the same for Constitutional purposes as requiring a more severe criminal penalty upon conviction if a person exercises his right to a jury trial rather than submitting his case to a judge. Indeed, the justification for the penalty Congress imposes in TEFRA -- efficient operation of government -- would justify

relinquishment of most of our personal liberties enshrined in the Bill of Rights. The adoption of the Bill of Rights was never viewed as promoting the efficiency of government.

The guiding principle was set forth in Frost Trucking Co. v. Railroad Commission, 271 U.S. 583 (1926):

> It would be a palpable incongruity to strike down an act of state legislation which by words of express divestment, seeks to strip the citizen of rights guaranteed by the federal Constitution, but to uphold an act by which the same result is accomplished under the guise of a surrender of a right in exchange for a valuable privilege which the state threatens otherwise to withhold.

Id. at 593.

The Tenth Amendment was ratified in 1791 as part of the Bill of Rights. Eight states voted for the Constitution only after proposing amendments to be adopted after ratification. All eight proposals included some version of what became the Tenth Amendment. Garcia v. San Antonio Metropolitan Transit Authority, 469

U.S. at ___, 105 S. Ct. at 1027-28. Ratification was based upon the promise of dual sovereignty between the National and State government.

Chief Justice Stone stated it was intended "to allay fears that the new national government might seek to exercise powers not granted, and that the states might not be able to exercise fully their reserved powers." United States v. Darby, 312 U.S. 100, 124 (1941). The Tenth Amendment reserves powers not delegated "to the states respectively or to the people." Jefferson recognized "the true barriers of our liberty in this country are our State governments." D. Malone, Jefferson and the Ordeal of Liberty, 394 (1962).

If registration of state bond issues is desirable, there are means available to the United States Congress and to the Secretary of the Treasury to achieve registration -- means apparently not investigated or considered when

the current sanction was conceived. Chapoton Tr. 915-918. Those means would have achieved registration, at least in the opinion of the Assistant Treasury Secretary, who crafted the current sanction. Id. 917-918. 3/ Unlike Section 310(b)(1), they do not erode the basic tenet of Federalism.

3/ But even Mr. Chapoton admitted that a perfect system of tax collection is not possible for our federal system or even for the national government. Tr. at 921. Justice Butler, dissenting in Mountain Producers, observed:

> As to that principle [reciprocal tax immunity], the urgency of governmental demand for money does not justify yielding here.

303 U.S. at 387.

I. Application of Section 103 arrogates unto Congress power which has no limits, and destroys the Constitutional Equipoise between the National and State Government.

One theme has been constant through the history of the tax immunity doctrine from The Federalist to Pollock, the last case to treat the tax-exempt status of interest paid on government obligations: once allowed, the power to tax would have no limits. That is the reason for Marshall's warning that the power to tax involves the power to destroy. The Court later applied that warning to a statute such as Section 310(b)(1):

> [T]he power to destroy which may be the consequence of taxation is a reason why the right to tax should be confined to subjects which may be lawfully embraced therein, although it happens that in some particular instance no great harm may be caused by the exercise of the taxing authority as to a subject which is beyond its scope.

Knowlton v. Moore, 178 U.S. 41, 60 (1900).

The total want of power in the one sovereign to tax the obligations (including income therefrom) of the other sovereign, prevents even the attempt to tax because the attempt itself abuses the affected sovereign. The Court has so stated from Weston to Gerhardt.

Justices Douglas and Black, dissenting in New York v. United States, cautioned:

> A tax is a powerful, regulatory instrument. Local government in this free land does not exist for itself.... Local government exists to provide for the welfare of its people.... If the federal government can place the local governments on its tax collector's list, their capacity to serve the needs of their citizens is at once hampered or curtailed.

376 U.S. at 593. They went on:

> The power to tax is indeed one of the most effective forms of regulation. And no more powerful instrument for centralization of government could be devised.

Id. at 594.

These fears are apropos. The political dialogue surrounding the adoption of the Sixteenth Amendment assumes the interest upon state obligations would be protected against federal taxation. The amicus brief of the Government Finance Officers' Association aptly describes the congressional march away from the assurances given the states when ratification was proposed, to the recent congressional pronouncement that taxation of state bond interest income is debatable. Indeed, recent political debate makes clear the national government wishes to assert its ability to tax the proceeds of state bond issues. Amicus Curiae Brief of The Government Finance Officers Association.

Congress has enacted a so-called minimum tax, which includes within the definition of income the interest on state bonds. Social Security Amendments of 1983, Pub. L. No. 98-21, Section 121, 97 Stat. 65. The 1986 Tax Reform

Act, Pub. L. No. 99-514 limits the issuance of tax immune bonds for purposes and amounts approved by Congress. It refers to the "exemption" rather than the "immunity" of the States. Title XIII, Secs. 1301 Y et seq.

Professor Tribe has described the danger of Congressional encroachment upon State sovereignty:

> Of course, no one expects Congress to obliterate the states, at least not in one fell swoop. If there is any danger, it lies in the tyranny of small decisions -- in the prospect that Congress will nibble away at state sovereignty, bit by bit, until someday essentially nothing is left but a gutted shell.

L. Tribe, American Constitutional Law, Section 5-20, at 302 (1978).

J. Garcia does not apply to Federal taxation of State bond proceeds.

In Garcia v. San Antonio Metropolitan Transit Authority, 469 U.S. 528 (1985), the

Court upheld an act of Congress supported by the Commerce Clause which imposed federal minimum wage -- maximum hour provisions of the Fair Labor Standards Act to the states and their instrumentalities. The Special Master observed "Garcia altered the landscape of federalism jurisprudence, but left the judicial mapping of the new terrain of federalism to future cases." Report at 117.

In Garcia the Court concluded the political procedural safeguards in the Constitution protect the states' interests from overreaching congressional regulation pursuant to the Commerce Clause. The logic of Garcia is inapplicable to federal taxation of state bond income. First, history teaches us that the Framers conceded the necessity of concurrent jurisdiction between the federal and state governments to raise revenue. Hamilton concluded the states could not be treated as subordinate creatures in an area of taxation;

however, the Constitution grants power to the federal government to preempt the field of interstate commerce.

The Court has said "[p]erhaps the two most authoritative persons in the Convention, touching the Constitution, were Hamilton and Madison." Springer v. United States, 102 U.S. 586, 597 (1881), and that when the scope of a constitutional amendment is unclear, no inquiry is "more appropriate[ ], we think, than to the history of the times in the midst of which the provision was adopted." Reynolds v. United States, 98 U.S. 145, 162 (1879). In consideration of the Establishment Clause, the Court has paid particular deference to Jefferson's views upon the belief that "[c]oming as this does from an acknowledged leader of the advocates of the measure, it may be accepted almost as an authoritative declaration of the scope and effect of the amendment thus secured." Id. at 164.

No one doubts Hamilton's advocacy for a strong central government, but as to taxation, he stated:

> [y]et I am willing to allow, in its full extent, the justness of the reasoning which requires that the individual States should possess an independent and uncontrollable authority to raise their own revenues for the supply of their own wants. And making this concession, I affirm that (with the sole exception of duties in imports and exports) they would, under the plan of the convention, retain that authority in the most absolute and unqualified sense; and that an attempt on the part of the national government to abridge them in the exercise of it would be a violent assumption of power, unwarranted by any article or clause of its Constitution.

The Federalist No. 32 at 197-98 (Hamilton).

Second, the history of federal sensitivity to the burdens imposed upon state and local governments when Congress regulates commerce recited in Garcia is not present in the area of taxation. Because the two sovereigns are competing for revenues, it is folly to suggest that the political process affords the states

protection. Review of this Court's decisions since M'Culloch v. Maryland, reveals the friction between the federal and state governments in areas of taxation.

Third, in Garcia, the Court noted "[o]f course, we continue to recognize that the states occupy a special and specific position in our constitutional system..." 469 U.S. at ___, 105 S. Ct. at 1020. The states cannot be viewed as a monolithic lobbying group juxtaposed against the federal bureauacracy and Congress. When each State ratified the Constitution, it entered into a covenant to retain certain individual sovereignty. The Tenth Amendment was not just a collective bargaining agreement for the states to exercise as a union of states against the National Government.

This Court's recent decision in Pennzoil Co. v. Texaco, 107 S. Ct. 1519 (1987), quoting Younger v. Harris, 401 U.S. 37, 44 (1971),

speaks to our notions of federalism, and the respect necessary to be paid to each state:

> What the concept does represent is a system in which there is sensitivity to the legitimate interests of both State and National Governments, and in which the National Government, anxious though it may be to vindicate and protect federal rights and federal interests, always endeavors to do so in ways that will not unduly interfere with the legitimate activities of the States.

Id. at 1525-26 (quoting from Younger v. Harris, 401 U.S. 37, 44 (1971))

For the Court to abandon the holding of Pollock and sustain the challenged act would expand Justice Powell's concern expressed in Garcia that "[d]espite some genuflecting in Court's opinion to the concept of federalism, today's decision effectively reduces the Tenth Amendment to meaningless rhetoric when Congress acts pursuant to the Commerce Clause." 469 U.S. at ___, 105 S. Ct. at 1022 (Powell, J., dissenting). The challenged act is illustrative of Justice O'Connors observation

that "all that stands between the remaining essentials of state sovereignty and Congress is the latter's underdeveloped capacity for self-restraint." Id. at 1037.

The Court must decide whether "our federalism" will survive into the third century of the Constitution. The promise of dual sovereignty between the national government and the states was an essential part of the ratification process. The sovereignty retained by the states was their flagship against encroachment by the national government. The states must not be reduced to empty vessels traveling to Washington to lobby for those benefits and bounty the national government will bestow.

> Federalism is both a constitutional principle and a practical strategy for good government. It is not an antiquated idea. It makes good sense today, as it did two hundred years ago. Those who argue that any attempt at revitalizing federalism is doomed to failure -- because the problems of government today are so different from the kinds of problems

> confronting the Framers -- fail to recognize that while the particular issues differ, political principles that provide the foundation of those issues are the same.

The Status of Federalism in America: A Report of the Working Group on Federalism of the Domestic Policy Council 59 (1986).

Moreover, Federalism promotes Hobbes' notion that "freedom is political power divided into small fragments." S. Ervin, Preserving the Constitution 72 (1984). Woodrow Wilson observed that the "concentration of powers is what always precedes the destruction of human liberties." Id. at 73. Justice Powell wrote in dissent in Garcia:

> [T]he harm to the States that results from federal overreaching under the Commerce Clause is not simply a matter of dollars and cents. . . .Nor is it a matter of the wisdom or folly of certain policy choices. . . . Rather, by usurping functions traditionally performed by the States, federal overreaching. . . undermines the constitutionally mandated balance of power between the

> States and the federal government, a balance designed to protect our fundamental liberties.

469 U.S. at ___, 105 S. Ct. at 1029.

For the foregoing reasons, the Court must not cavort with the other branches of the national government and uphold Section 301 -- an Act which has taken more than the unconstitutional nibble feared by Tribe.

II. SECTION 310(b)(1) OF THE ACT VIOLATES THE TENTH AMENDMENT TO THE UNITED STATES CONSTITUTION BY REGULATING SOUTH CAROLINA'S POWER TO BORROW MONEY AND ITS RESERVED POWERS.

A. Section 310(b)(1) as impermissible burden and regulation of State's borrowing power.

The power to borrow money is an essential power of government. Smyth v. United States, 302 U.S. 329, 362-63 (1937) (Stone, J., concurring); Willcuts v. Bunn, 282 U.S. at 225; Weston v. The City of Charleston, 27 U.S. (2 Pet.) at 467. In Pollock, the Court held that

> under the fundamental law, as to the power to borrow money, neither the United States, on the one hand, nor the states on the other, can interfere with that power as possessed by each, and an essential element of the sovereignty of each.

157 U.S. at 585.

Bond issues are used to fund critical state projects. Nationally, over $500 Billion

of municipal bonds are outstanding. In 1974, $23 Billion worth of new municipal bonds were issued. In 1983, $83 Billion were issued. In 1984, $102 Billion of new municipal bonds were issued. STIPULATION OF FACTS Nos. 8-10. There are approximately 47,000 issuers of municipal bonds in the United States. These issuers include states, counties, parishes, boroughs, cities, townships, school districts, special purpose districts, authorities and commissions. Id. No. 11.

The share of state and local government spending covered by borrowing has assumed an ever more important role in the capital budgeting of state and local governments because of relative decreases in federal grants. Id. Nos. 4 and 108. For example, in South Carolina, excluding construction of highways and electrical generation facilities, 46% of the funds required for current capital projects will be provided by issuing state and

agency bonds. Only 3% of the funds necessary for these projects will come from the federal government. PL. EX. 132.

The borrowing power is closely associated with the power to tax. Both powers raise funds to carry on the essential operations of government. In South Carolina, while the operating budget is funded through taxes, the capital budget is largely dependent upon borrowing. Borrowing is as essential to the capital budget as taxes are to the operating budget. Patterson Tr. 428-429, 438-439.

Independence in the exercise of authority to fund the government is essential to an independent government. Interference with a funding source necessarily interferes with and threatens independent existence.

Section 310(b)(1) also works an undue interference with the states' sovereignty; it adds cost to state and local issuers of debt. The registration requirement imposed new costs

upon state and local issuers of public debt. These new costs include the cost of procuring and retaining a registrar and transfer agent for each bond issue. The registration requirement requires the state to keep a record of each holder of its outstanding bonds. Under the bearer system, it was not necessary to incur the cost of this record keeping. Additionally, it is necessary to hire a transfer agent. This transfer cost was not incurred under the bearer system. The cost of preparing and mailing interest checks is paid by the state under the registered system whereas it was not a cost to the state under the bearer system. In short, under the registration system the public issuer has been forced to pay costs which were not incurred under the bearer system. See, STIPULATION OF FACTS Nos. 14, 15, 18 and 19.

Most bond issues are in amounts of $10 Million or less. STIPULATION OF FACTS No. 13;

PL. In 1983, 76% of bond issues were in this category. Report at 21. The ongoing administrative costs for registered bonds exceed those for bearer bonds for issues of $10 Million or less. Report at 41 and 43. The Government Finance Research Center ["GFRC"] study, endorsed by the Defendant, found that registration raises ongoing administrative costs significantly over the life of those issues. Additionally, costs associated with paying interest and principal to bondholders have increased considerably for these issuers.

The Defendant urged the hardships and added expense could be diminished by pure book entry system and statewide pooling arrangements. "However, the Secretary [Defendant] presented no evidence indicating any post-TEFRA increase in the use of these systems by smaller issuers." Report at 43-44.

The Defendant did not address whether such pooling arrangements would require state

constitutional amendments or statutory enactments. In FERC v. Mississippi, 456 U.S. 742, 761-62 (1982), the Court noted it had "never...sanctioned explicitly a federal command to the States to promulgate and enforce laws and regulations." The Special Master found in order to comply with TEFRA, the states were obligated to enact numerous statutory and administrative changes and expend "not insignificant" sums of money. Report at 36-40.

In South Carolina, considering all state issues regardless of size, average original issuance costs and ongoing administrative costs have increased under the registered system from $14.28/$1000 principal for bearer bonds issued from 1979 through 1982 to $24.41/$1000 principal for registered bonds issued subsequent to 1982. PL. EX. Nos. 149 and 150.

The registration requirement has also imposed a considerable interest rate penalty upon issuers of public debt. The interest

component of state and local borrowing is significant; for example, at rates prevailing in March, 1984, the interest paid on a debt due in 20 years represented approximately 70% of total payments. PL. EX. No. 126 at 14. The interest rate penalty burden is imposed upon state and local governments each time they go to market and throughout the life of those bonds issued after July 1, 1983.

Interest rates are affected by investor preference for bearer bonds. Prior to the registration requirement investors in South Carolina bonds were given a choice to hold either bearer or registered bonds. Fully 97% of all bonds were held in bearer form. The interest rate penalty caused by the registration requirement is estimated to range up to 25 basis points. Patterson Tr. 448-451.

Professor Leonard demonstrated a penalty of 5 to 15 basis points. [4/]

The defendant's market witnesses estimated that there is no interest penalty. The defendant's expert, however, was unable to support that thesis. In fact, his data were ultimately used to corroborate Professor Leonard's findings. This penalty has resulted in added interest costs of $140 Million to $420 Million in one year and $4.2 Billion to $12.6 Billion over thirty years nationwide.

The National Government contends the Plaintiff failed to prove that investors preferred bearer bonds for valid reasons. It speculates the preference, if any, is based solely upon the investors desire to conceal capital gains, gift and estate income subject

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4/ The Master found against South Carolina on this point; however, he adopted a seemingly inconsistent position that although bond holders were given the opportunity to convert to registered form "only a tiny minority. . . chose to convert." Report at 23 n. 72.

to federal taxation. No competent proof was offered by the Defendant. The Master stated: "The dominance of bearer securities appears to have been due not to investor preference, but to the absence of an impetus or motivation to change." Report at 48.

The Master's assumption is unsupported by the record. Additionally, the analysis is flawed. It assumes the State has an obligation to expend money on a public relations campaign to convince the public to prefer registered bonds.

Registrated bonds have features which should commend them to many investors. Direct deposit of employee checks to banks, automatic withdrawal for periodic payments, and no stop electronic teller machines likewise have attractive features. Yet, it probably would not surprise this Court that many people do not use these services, although they may be more convenient. In the absence of proof, the

Plaintiff doubts the Court would assume all those who choose even more cumbersome methods of depositing or withdrawing money from banks and spending time in teller lines or paying bills by check rather than direct employee deductions do so for illegal purposes. The Defendant offered no competent proof to support the assumption.

B. Section 310(b)(1) as violative of states' political processes.

The Tenth Amendment guarantees to the states the power to establish and maintain their own separate and independent governments. Oregon v. Mitchell, 400 U.S. 112 (1970). Borrowing money is intimately tied to the states' political processes. In Garcia, the Court relied upon the political process in our federal system to ensure the continued

existence of the states. 469 U.S. at ___, 105 S. Ct. at 1018-19. Implicit in reliance on the democratic political process at the national level is protection of the democratic process at the state level. See U.S. CONST. art. IV, §4, cl. 1 ("The United States shall guarantee to every State in this Union a Republican Form of Government").

The political process includes choice among competing interests for limited resources. The decision to borrow money, the means employed to do so and the use made of the proceeds are inseparable from the political process. Future tax revenues are necessarily pledged for repayment, thus ultimately tying the power to borrow to the power to tax.

South Carolina performs its governmental functions and provides services and facilities through expenditure of money. Expenditures in the State are divided into two categories: operational and capital. The capital

expenditures are for public improvements which have a long-term life expectancy. The State and its political subdivisions construct public buildings, schools, highways and bridges for the conduct of government, education of its citizens and efficient and safe transportation of goods and services in the State. Patterson Tr. 428-429, 438-439.

The capital needs of the State of South Carolina are increasing. From 1981 to 1984, outstanding debt at the State level increased by $55 Million. PL. EX. 130. Nationally, considering only those facilities owned by state and local governments, an annual capital need of approximately $70.3 Billion (in 1982 dollars) must be financed by states and localities from their own resources through 1989. This represents a 52% increase over the current level of spending. Most of the increase in capital spending will need to be financed by borrowing. PL. EX. 126 at 1, 12; Report at 21.

The State determines its capital needs, the priority of those needs and the source of funding for those needs through a capital budget process. Every two years State agencies and departments submit capital budgets to the State Budget and Control Board which conducts hearings, receives testimony and studies the capital needs of the State. This process results in a capital budget which is submitted to the State Legislature.

The Legislature determines priorities and authorizes funding for these projects. The process is uniquely governmental. The needs, desires and resources of an entire community are raised, considered and given priority. Borrowing is the means to ensure the continued vitality of these functions. By Section 310(b)(1), Congress has invaded the central decision-making processes of local government.

The power to borrow money includes the power to determine the form of the debt. See

Free v. Bland, 369 U.S. 663, 666-67 (1962) (U.S. savings bonds). Section 310(b)(1) has completely pre-empted state exercise of this choice.

State sovereignty includes the power to make basic organizational and operational decisions, particularly in finance. Section 310(b)(1) removed the states' right to decide the form of bonds to issue; it eliminated their authority to tailor the form of issuance to fit the needs of issuers and investors. The requirement that debt be issued in registered form dictates the policy decision of the form of the debt to the governments charged with the authority to issue debt and the responsibility to repay it.

C. Section 310(b)(1) as regulatory tax.

The tax imposed on municipal bonds if not issued in registered form is a penalty. No

revenue is sought to be obtained by Section 310(b)(1). South Carolina v. Regan, Tr. Oral Arg. 20. The tax is an unconstitutional penalty. While the Court gives wide latitude to exercise of the taxing power, it cannot regulate where no revenue is raised. United States v. Kahriger, 345 U.S. 22, 28 (1953) overruled on other grounds, Marchetti v. United States, 390 U.S. 39, 58 (1968); Carter v. Carter Coal Co., 298 U.S. 238, 289 (1936); Child Labor Tax Case (Bailey v. Drexel Furniture Co.), 259 U.S. 20, 37-39 (1922); Hill v. Wallace, 259 U.S. 44, 65-68 (1922). In United States v. Kahriger, the Court upheld a tax upon wagering against an allegation that it was an invalid exercise of the taxing power because the tax was supportable as a revenue-raising enactment. In its opinion the Court cited Child Labor Tax Case, and Hill v. Wallace, with approval as to the following language:

> Penalty provisions in tax statutes added for breach of a regulation concerning activities in themselves subject only to state regulation have caused this Court to declare the enactments invalid.

345 U.S. at 31 (footnote omitted).

Congress has attempted to regulate the states through a tax device. Assuming the device (denial of tax-exemption to interest earned on state bonds) is not a revenue measure, but merely seeks to regulate an essential state activity, it is an invalid attempt to invoke the power of taxation.

D. The Nature of Judicial Inquiry Into the State's Loss of Essential Attributes of Sovereignty.

In Garcia, the Court said states "retai[n] a significant measure of sovereign authority," 469 U.S. at ___, S. Ct. at 1017 (quoting from EEOC v. Wyoming, 460 U.S. at 269 (Powell, J., dissenting)), but that authority is with

exceptions, usually "protected by procedural safeguards inherent in the structure of the federal system." Id. at ___, 105 S. Ct. at 1018. The Court found that the internal safeguards of the political process had resulted in Congress not overstepping its authority with respect to the states. Id. at ___, 105 S. Ct. at 1020.

Garcia dealt with the extent of Congress' power under the Commerce Clause, U.S. CONST. art. I, §8, cl. 3. In most respects, therefore, it is not applicable to the present controversy. The Commerce Clause grants broad authority to Congress to regulate the national economy. FERC v. Mississippi, 456 U.S. at 753-54. "It is elementary and well settled that there can be no divided authority over interstate commerce, and that the acts of Congress on that subject are supreme and exclusive." Missouri Pacific Railroad Co. v. Stroud, 267 U.S. 404, 408 (1925) (quoted in

Hodel v. Virginia Surface Mining and Reclamation Association 452 U.S. 264, 290 (1981)). Congress regulates the economy through exercise of the Commerce Clause authority. See Usery v. Turner Elkhorn Mining Co., 428 U.S. 1, 15 (1976) (Commerce Clause involves "legislative Acts adjusting the burdens and benefits of economic life"). This, presumably, prompted the Court to adopt a general rule, with important exceptions discussed later, of deferring to Congress as it has done in Commerce Clause cases not involving regulation of the states. In the present case Congress is acting pursuant to its taxing power. 5/ As argued earlier, the states also

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5/ The different treatment under the taxing power and the Commerce Clause power is illustrated by Hill v. Wallace, 259 U.S. 44 (1922), and Chicago Board of Trade v. Olsen 262 U.S. 1 (1923). In 1921, Congress enacted the Future Trading Act, which imposed a prohibitive tax on grain futures transactions that were not consummated on an exchange designated as a "contract market" by the Secretary of

have a sovereign taxing power. See New York v. United States, 326 U.S. at 576 n. 2.

To the extent Garcia can be applied to the instant case, the limitations upon federal power inherent in the federal system described there have been exceeded. The Court explicitly recognized that there are two kinds of substantive restraints on Congress' authority in this area. First, restraints designed to compensate for possible failings in the national political process, 469 U.S. at ___, 105 S.Ct. at 1019-1020, and, second, restraints which preclude a complete assumption of state authority. Id. at ___, 105 S.Ct. at 1020 (citing Coyle v. Oklahoma, 221 U.S. 559 (1911)).

Agriculture. The 1921 statute was held unconstitutional as an improper exercise of the taxing power in Hill, but its regulatory provisions were promptly re-enacted in the Grain Futures Act and upheld under the Commerce Clause power in Chicago Board of Trade. See Merrill Lynch, Pierce, Fenner & Smith v. Curran, 456 U.S. 353, 360-61 (1984).

A significant issue before the Court is the formulation a method to recognize such a failure, a method to test the efficacy of the process.

The usual inquiry for the judicial branch when confronted with a question of the exercise of Congress' authority under the Commerce Clause is whether Congress had a rational basis for finding that the object of regulation affected interstate commerce and, if so, whether the means chosen by Congress to regulate the object so affecting commerce are reasonable and appropriate. See, e.g. Heart of Atlanta Motel v. United States, 379 U.S. 241, 258 (1964).

The Defendant has argued the "rational relationship" test is the proper test to apply to the congressional action challenged here. It is not. First, the exercise of congressional authority under the Commerce Clause cannot be equated to the taxing power.

Second, when a state is the subject of regulation, competing principles of federalism recognized in Garcia must be protected.

When a statute is challenged as an undue burden on an activity granted constitutional protection, degree of inquiry is that which is necessary to protect the competing constitutional value from erosion. Austin v. New Hampshire, 420 U.S. 656, 662 (1975) (state tax). This consideration applies equally to the protection of individual liberties and to the maintenance of federalism. Id. A "standard of review substantially more rigorous," Id. at 663, than that applied to private businesses or different trades or professions is required.

To determine whether the political process performed as intended, the Court must look to the process itself.

E. The Record Before Congress

The record shows that the political process failed to perform as intended. The burdens imposed by Section 310(b)(1) were imposed by the vote of an uninformed Congress relying upon incomplete information.

Congress set forth three reasons for requiring registration of bearer bonds.

> (1) The Committee believes that a fair and efficient system of information reporting and withholding cannot be achieved with respect to interest-bearing obligations as long as a significant volume of long-term bearer instruments is issued. A system of book-entry registration will preserve the liquidity of obligations while requiring the creation of ownership records that can produce useful information reports with respect to both the payment of interest and the sale of obligations prior to maturity through brokers.
>
> (2) Furthermore, registration will reduce the ability of noncompliant tax-payers to conceal income and property from the reach of the income, estate, and gift taxes.

> (3) Finally, the registration requirement may reduce the volume of readily negotiable substitutes for cash available to persons engaged in illegal activities.

S. REP. No. 494, 97th Cong., 2d Sess. 242 (1982). JT. EX. No. 86.

These three reasons essentially track the testimony of Assistant Treasury Secretary Chapoton before the House Ways and Means Committee in support of the registration requirement. Mr. Chapoton testified he did not have any evidence supporting these asserted justifications other than anecdotes. Report at 84. The Master found there was no evidence in the record quantifying tax evasion. Id.

The first justification, promotion of a fair and efficient system of information reporting, is completely without support since information reporting on the sale of municipal bonds is precisely the same for bearer and registered bonds. Report at 84-86.

The second part of this justification, income tax compliance, relates to capital gains income tax and concealment in bearer bonds of taxable income. Mr. Chapoton testified he had no specific evidence that bearer bonds were used to avoid capital gains tax. Chapoton Tr. 953.

As to the concealment justification, Mr. Chapoton had no specific evidence at the time he testified before Congress that bearer bonds were used for this purpose. Chapoton Tr. 951-952.

The Defendant offered no proof concerning the third justification.

F. Application of Judicial Inquiry to the Record Before the Court

In Garcia, the Court concluded it could review failings in the national political process, or situations in which legislation

completely assumed state authority. The Court said the constitutional structure imposes affirmative limits on federal action affecting the states under the Commerce Clause, citing Coyle v. Oklahoma, 221 U.S. 559 (1911).

Coyle v. Oklahoma involved an attempt by Congress to designate the temporary location of Oklahoma's capital upon its admission to the Union. The Court held:

> the power to locate its own seat of government, and to determine when and how it shall be changed from one place to another, and to appropriate its own public funds for that purpose, are essentially and peculiarly state powers. That one of the original thirteen states could now be shorn of such powers by an act of Congress would not be for a moment entertained.

221 U.S. at 565.

The Court quoted Lane County v. Oregon, 74 U.S. (7 Wall.) 71, 76 (1869), with approval:

> [T]he people of each State compose a State, having its own-government, and endowed with all the functions essential to separate and independent existence.

221 U.S. at 580.

The Government has not argued a constitutional limitation upon the states' authority to borrow money. Rather, it seeks to regulate the valid exercise of the legitimate, necessary governmental activity of raising money through borrowing. It has done so without exhibiting the necessity of the statute. Regulation of an admittedly valid source of funds creates a dependency upon Congressional grace with a concomitant loss of independence. The Special Master found "the statutory sanction is real and exercises a powerful effect upon the states." Report at 148, n. 444. Regulation of a recognized, constitutional source of financing threatens the independence of the states.

G. The Master's Discussion of the Plaintiff's Acquiesce is Irrelevant and Incorrect

South Carolina's Complaint charged that "in the course of the exercise of its sovereign responsibility, South Carolina must borrow money to enable it to function effectively as a provider of services essential to the health and welfare of its citizens." Comp., Paragraph 4, and pursuant to the Constitution of South Carolina it is authorized "to borrow money and to issue general obligation and other bonds." It alleged application of TEFRA's registration requirement to "the general obligations of South Carolina causes irreparable injury to South Carolina and results in the destruction of its sovereignty for which there is no remedy." Id. Paragrah 10.

The Special Master discussed at some length congressional regulations dealing with industrial development bonds and arbitrage

bonds. The question of whether those bond proceeds are immune from federal taxation is not before the Court. Moreover, the Master's discussion of the states' acquiesence in unrelated congressional regulations is inappropriate. The Defendant claims the Plaintiff acquiesed in those regulations and chose not to contest them. Yet from the moment South Carolina asked this Court for relief, the Defendant argued that even this Court was powerless to enjoin the enforcement of the challenged act. Fortunately, this Court did not agree. South Carolina v. Regan, supra.

CONCLUSION

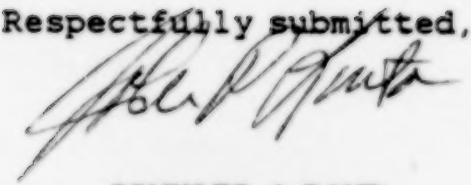
Section 310(b)(1) is constitutionally infirm for two reasons. It asserts congressional controls in a field preserved to the states, thus impermissibly intruding on the sovereignty of the states, and, in blind-side fashion, it unconstitutionally asserts the right of the national government to tax the interest paid by states on their debt obligations despite clear and sound precedent to the contrary.

The contitutional powers of the states must not be carelessly abrogated. The continued existence of the federal system secures the liberties of the citizens of the United States as no other form of government could and far outweighs any remote administrative convenience attaching to the plan here promoted by the United States Congress. That plan must be judicially voided.

RELIEF REQUESTED

The Plaintiff, the State of South Carolina, prays that the Court enter a decree adjudging Section 310(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982 as applied to the general obligations of South Carolina to be in violation of the Constitution of the United States; and that the Court enter a decree permanently enjoining and restraining the Defendant from enforcing or attempting to enforce Section 310(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982 against the general obligations of South Carolina; and for such other and further relief as it may deem proper and necessary.

Respectfully submitted,



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May 8, 1987,

Charleston, South Carolina.

Appendix A

STATE OF NEW YORK

EXECUTIVE CHAMBER,

ALBANY

January 5, 1910.

To the Legislature:

I have received from the Secretary of State of the United States a certified copy of a resolution of Congress entitled "Joint Resolution Proposing an Amendment to the Constitution of the United States," and in accordance with his request I submit it to your honorable body for such action as may be had thereon.

The amendment proposed by this joint resolution, adopted by two-thirds of both houses of Congress, is as follows:

> "Article XVI. The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

The power to lay a tax upon incomes, without apportionment, was long supposed to be possessed by the Federal government and has been repeatedly exercised. Such taxes were laid and paid for the purpose of meeting the exigencies caused by the Civil War.

In 1895, in the case of Pollock v. Farmers' Loan & Trust Company (158 U.S. 601), the United States Supreme Court decided that taxes on the rents or income of real estate, and taxes on personal property or on the income of personal property, are direct taxes and hence under the Constitution cannot be imposed without apportionment among the several States according to their respective populations.

It was not the function of the court, and it did not attempt, to decide whether or not a Federal income tax was desirable. It simply interpreted the Constitution according to the judgment of the majority of its members and left the question of the advisability of conferring such a power upon the Federal government to be determined in the constitutional method.

The limitations so placed upon the Federal taxing power are thus described by Mr. Justice Harlan in his dissenting opinion:

"Any attempt upon the part of Congress to apportion among the States, upon the basis simply of their population, taxation of personal property or of incomes, would tend to arouse such indignation among the freemen of America that it would never be repeated. When, therefore, this court adjudges, as id does not adjudge, that Congress cannot impose a duty or tax upon personal property, or upon income arising either from rents of real estate or from personal property, including invested personal property, bonds, stock and investments of all kinds, except by apportioning the sum to be so raised among the States according to population, it practically decides that, without an amendment of the Constitution -- two-thirds of both Houses of Congress and three-fourths of the States concurring -- such propoerty and incomes can never be made to contribute to the support of the national government. (Id., pp. 671, 2) * * *

"Incomes arising from trades, employments, callings, and professions can be taxed, under the rule of uniformity or equiality, by both the national government and the respective State governments, while incomes from property, bonds, stocks, and investments cannot, under the present decision, be taxed by the national government except under the impracticable rule of apportionment among the States according to population. No sound reason for such a discrimination has been or can be suggested." (Id., p. 680.)

I am in favor of conferring upon the Federal government the power to lay and collect an income tax without apportionment among the States according to population. I believe that this power should be held by the Federal government so as properly to equip it with the means of meeting national exigencies.

But the power to tax income should not be granted in such terms as to subject to Federal taxation the incomes derived from bonds issued by the State itself, or those issued by municipal governments organized under the State's authority. To place the borrowing capacity of the State and of its governmental agencies at the mercy of the Federal taxing power would be an impairment f the essential rights of the State which, as its officers, we are bound to defend.

You are called upon to deal with a specific proposal to amend the Constitution, and your action must necessarily be determined not by a general consideration of the propriety of a just Federal income tax, but whether or not the particular proposal is of such a character as to warrant your assent.

This proposal is that the Federal Government shall have the power to lay and collect taxes on incomes "from whatever source derived."

It is to be borne in mind that this is not a mere statute to be cnstrued in the light of constitutional restrictions, express or implied, but a proposed amendment to the Constitution itself which, if ratified, will be in effect a grant to the Federal government of the power which is defines.

The comprehensive words, "from whatever source derived," if taken in their natural sense, would include not only incomes from

ordinary real or personal property, but also incomes derived from State and municipal securities.

It may be urged that the amendment would be limited by construction. But there can be no satisfactory assurance of this. The words in terms are all-inclusive. An amendment to the Constitution of the United States is the most important of political acts, and there should be no amendment expressed in such terms as to afford the opportunity for Federal action in violation of the fundamental conditions of State authority.

I am not now referrring to the advantage which the State might derive from the exclusive power to tax incomes from property, or to the argument tha tfor this reason the power to tax such incomes should be withheld from the Federal government. To that argument I do not assent.

I am referring to a proposal to authorize a tax which might be laid in fact upon the instrumentalities of State government. In order that a market may be provided for State bonds, and for municipal bonds, and that thus means may be afforded for State and local administration, such securities from time to time are excepted from taxation. In this way lower rates of interest are paid then otherwise would be possible. To permit such securities to be the subject of Federal taxation is to place such limitations upon the borrowing power of the State as to make the performance of the functions of local government a matter of Federal grace.

This has been repeatedly recognized. In the case of The Collector v. Day (11 Wall. on p. 127), decided in 1870, the United States Supreme Court said:

> "It is admitted that there is no express provision in the Constitution that prohibits the general government from taxing the means and instrumentalities of the States, nor is there any prohibiting the States from taxing the means and instrumentalities of that government. In both cases the exemption rests upon necessary implications, and is upheld by the great law of self-preservation; as any government, whose means employed in conducting its operations, if subject to the control of another and distinct government, can exist only at the mercy of that government. Of what avail are these means if another power may tax them at discretion?"

In the case of Pollock v. Farmers' Loan & Trust Co. (157 U.S. on pp. 584-5), Chief Justice Fuller said, referring to the tax upon incomes from municipal bonds, one of the matters there involved:

> "A municipal corporation is the representative of the State and one of the instrumentalities of the State government. It was long ago determined that the property and revenues of municipal corporations are not subjects of Federal taxation. * * *But we think the same want of power to tax the property or revenues of the States or their instrumentalities exists in relation to a tax on the income from their securities."

In the same case Mr. Justice Field said (Id. on p. 601):

"These bonds and securities are as important to the performance of the duties of the State as like bonds and securities of the United States are important to the performance of their duties, and are as exempt from the taxation of the United States as the former are exempt from the taxation of the States."

And the learned Justice added, quoting from United States v. Railroad Co. (17 Wall. on pp. 322, 327) as follows:

"The right of the States to administer their own affairs through their legislative, executive, and judicial departments, in their own manner through their own agencies, is conceded by the uniform decisions of this court, and by the practice of the Federal government from its organization. This carries with it an exemption of those agencies and instruments from the taxing power of the Federal government. If they may be taxed lightly, they may be taxed heavily; if justly, oppressively. Their operation may be impeded and may be destroyed, if any interference is permitted. Hence, the beginning of such taxation is not allowed on the one side, is not claimed on the other."

While the justices of the court in the Pollock case differed in opinion upon the question whether a tax upon income from property was a direct tax and as such could not be laid without apportionment, they were unanimous in their conclusion that no Federal tax could be laid upon the income from municipal bonds. Mr. Justice White, who dissented in the Pollock case with regard to other questions, as to this said (157 U.S. on p. 652):

"The authorities cited in the opinion are decisive of this question. They are relevant to one case and not to the other, because, in the one case, there is full power in the Federal government to tax, the only controversy being whether the tax imposed is direct or indirect; while in the other there is no power whatever in the Federal government, and, therefore, the levy, whether direct or indirect, is beyond the taxing power."

It is certainly significant that the words, "from whatever source derived," have been introduced into the proposed amendment as if it were the intention to make it impossible for the claim to be urged that the income from any property, even though it consist of the bonds of the State or of a municipality organized by it, will be removed from the reach of the taxing power of the Federal government.

The immunity from Federal taxation that the State and its instrumentalities of government now enjoy is derived not from any express provision of the Federal Constitution, but from what has been deemed to be necessary implication. Who can say that any such implication with respect to the proposed tax will survive the adoption of this explicit and comprehensive amendment?

We cannot suppose that Congress will not seek to tax incomes derived from securities issued by the State and its municipalities. It has repeatedly endeavored to lay such taxes and its efforts have been defeated only by implied constitutional restriction which this amendment threatens to destroy. While we

may desire that the Federal government may be equipped with all necessary national powers in order that it may perform its national function, we must be equally solicitous to secure the essential bases of State government.

I therefore deem it my duty, as Governor of the State, to recommend that this proposed amendment should not be ratified.

CHARLES E. HUGHES